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Joint Committee on Taxation
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Statement
of
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Joint Committee on Taxations

Before the
Senate Committee on Finance

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear before you today to discuss some of the issues involved in this Committee's consideration of the Administration's proposal to reinstitute a preferential capital gains rate.

I have two objectives this morning. First, to highlight some of the important policy issues relevant to the capital gains debate and second, to explain our estimate of the revenue impact of the Administration's capital gains proposal.

I. Introduction

Yesterday, we released a hearing pamphlet[1] intended to provide members of the Committee with background information that hopefully will be helpful in your consideration of various capital gains proposals. At pages 18-22, the pamphlet details a number of arguments in support of and in opposition to a preferential capital gains rate. This discussion, and my comments this morning, are not intended as a recommendation of a course of action; they are neither statements favoring nor opposing the Administration's proposal. Instead they are intended to highlight the very

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[1] Joint Committee on Taxation, Tax Treatment of Capital Gains and Losses, JCS-7-89, March 11, 1989.

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important policy considerations which have been largely ignored as we debate the revenue impact of capital gains rate change.

II. Policy Considerations

Because these issues are set out in some detail in the hearing pamphlet, I wish only to refer very briefly to those which I consider most significant.

Savings and Capital Formation - An important part of the historical debate on the tax treatment of capital gains has been the influence of a preferential capital gains tax rate on national savings and capital formation. While a reduction in the tax on capital gains may possibly create substantial unlocking effects, there is no clear evidence in the economic literature regarding the effect of this unlocking on national savings and capital formation.[2]

Holding period - Some suggest that it would be advantageous for the nation's business climate if investors held their assets longer. Our analysis suggests that a preferential rate for capital gains could lead to a shortening of holding periods, even under the Administration's 3-year holding proposal.

Inflation - Much has been said about the over taxation of inflationary capital gains. While a tax preference for capital gains would provide a crude offset to the effects of inflation, history shows us that the preference also creates opportunity for tax sheltering. A precise measurement of economic income would adjust for inflation.

Complexity - The Congress is continuously assaulted because of the increasing complexity of the tax laws. The elimination of the preferential rate for capital gains was one of the most significant, and perhaps the most significant, simplification of the business and investment tax system resulting from the Tax Reform Act of 1986. That is not to mean the 1986 Act achieved maximum simplification--distinction between capital and ordinary income remains in the Code for the purpose of limiting capital losses and in anticipation of a return of a preferential rate. Although complexity remains, it is much less than before the 1986 legislation. If Congress chooses not to enact a preferential tax rate for capital gains,

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[2] Neither the Joint Committee staff nor Treasury has attempted to predict whether the Administration's proposal would have any so-called supply-side response such as accelerated investment, GNP growth, or increased stock market activity.

substantial simplification possibilities remain in refining the distinction between capital and ordinary income.

III. Impact of Capital Gains on Federal Revenues

A. In General

As you are aware, one of the responsibilities of the Joint Committee is to provide estimates of the revenue impact of tax legislation under consideration by the Congress. A revenue estimate represents our best judgment of the increase or decrease in Federal receipts that would result from a change in the law. Our reference point for this purpose is the five-year budget baseline for Federal receipts provided to us by the Congressional Budget Office (CBO). Our revenue estimating conventions require that this baseline remain fixed throughout the relevant budget period; it is unaffected by any proposed tax law change. This baseline includes an estimate of the annual net dollar value of sales of capital assets, which we refer to as "capital gain realizations."

For most revenue estimates, we rely on large computerized microsimulation models of the U.S. tax system. Each computer model essentially is a sophisticated tax calculator. When we are asked to estimate the revenue impact of a proposed change in the tax law, the model permits us to calculate the income tax paid under present law and compare that tax with the hypothetical tax which would be paid if the law were changed. Additionally, we also can examine how the proposed law affects the after-tax distribution of taxpayer incomes.

Our individual and corporate computer models use as their primary input the confidential tax returns of individuals, corporations, and fiduciaries, drawn from a sample of actual tax returns filed by taxpayers. However, few of the requests for revenue estimates that we receive can be analyzed solely by looking at tax return data. Instead, they require additional data not readily available from the income tax return. Therefore, in providing the Congress with our revenue estimates, we rely on a number of other data sources. These include, but are not limited to, corporate financial statements, census surveys, data compiled by the Federal Reserve Board, the Social Security Administration, and the Commerce Department's Bureau of Economic Analysis, and the macroeconomic forecasts of various private firms.

In addition to analyzing the large amount of data at our disposal our estimators also take into consideration the anticipated taxpayer behavioral response to a proposed change in the law. Evaluation of taxpayer behavior is essentially a judgment call. The estimator's challenge is to make that call on the most educated basis possible. In doing so, we rely on empirical and theoretical research that has been

conducted by economists and others, both from the private sector and from various government agencies. Most importantly, to the extent history gives us some guidance as to taxpayer behavior, we rely heavily on it. For example, in 1981 we used the best available information to estimate what we thought would be a modest taxpayer response to the expansion of IRA eligibility. In fact, taxpayer response was substantial. Many more taxpayers created IRAs than we had predicted. Consequently, our estimate was wrong. However, because the changes in the law regarding IRAs made in 1981 and 1986 may help identify taxpayers' response to such changes, our future analyses of similar changes are likely to be more accurate.

Evaluating taxpayer behavior often involves balancing conflicting theoretical and empirical research. Arguably, there is no other area where this conflict is so evident as in the estimation of the revenue consequences of changes in the capital gains tax rate.

B. Revenue Estimates of Capital Gains

The decision to sell a capital asset, and to realize a gain or loss, is largely a discretionary decision on the part of an investor. Thus, in providing the Congress with revenue estimates relating to proposed changes in the individual tax rate on capital gains, we are faced with having to predict how taxpayers will respond to the new rate. We know very little about why investors choose to buy and sell assets; we do know that taxes are but one of many factors that enter into their decision-making process.

The economic literature on the effect of taxes on the decision to realize a capital gain, unfortunately, lacks consensus and, therefore, is not very helpful. This is both because of the wide range of estimates the economic literature has produced and the issues it fails to address. It has been our task to try to make some sense out of a diverse and complicated area while at the same time provide the Congress with a reasonable and prudent estimate of the effect of such a tax change.

C. Estimates of the Administration's Proposal

Table 1 contains our estimate of the Administration's capital gains proposal. Our estimate indicates that the Administration's proposal projects revenue increases in fiscal years 1989 and 1990 totaling $4.0 billion. Beginning in fiscal year 1991 we project revenue losses for that and each succeeding year. The total effect for fiscal years 1989 through 1994 is to reduce Federal revenues by $24.2 billion. The CBO baseline projections do not extend beyond 1994. We have extended our estimate beyond the conventional budget period by assuming approximately the same rate of economic

growth as occurred in the 1990 to 1994 period. We estimate that for the period from fiscal year 1989 through 1999, the total effect of the Administration's proposal is to reduce Federal revenues by $67.0 billion.

As you can see from lines 1 and 2 of Table 1, our estimate of providing a 45 percent exclusion for the gain on certain assets sold on or after July 1 of this year assumes that taxpayers respond to his lower rate by selling existing assets to such an extent that federal tax revenues are increased, over and above the budget baseline for fiscal years 1989 and 1990. This increase in revenues results from taxpayer sales of capital assets in response to a change in the rate -- this is the so-called short-run unlocking effect. It was observed following the 1978 and 1981 rate reductions; not surprisingly it also was observed in 1986 following passage of the 1986 Act but before the repeal of the capital gains preference took effect (see Table 2 and Figure 2).

We believe this initial "unlocking" of unrealized capital gains is a temporary phenomenon and that after an adjustment period, taxpayers will settle in to a lower, more permanent level of realizations. This is not to say that the level of capital gains realization will return to its level prior to a rate reduction. To the contrary, our revenue estimate assumes that individual taxpayers will realize more than $600 billion in capital gains during the budget period in excess of what would have been sold at the higher (current) tax rate.

The Administration's proposal reduces the tax rate on capital gains by close of 50 percent. As a result, if Federal revenues are to remain unchanged, realizations must double. If a permanent revenue gain is predicted, realizations must more than double. In our judgment, we do not think the historical record supports that result.

D. Differences Between the Joint Committee and Treasury Estimates

There are several differences between our estimate of the Administration's capital gain proposal and that provided by the Treasury Department's Office of Tax Analysis.

The vast majority of the difference in the estimates lies in the assumptions made about taxpayers' behavioral response to a reduction in capital gains tax rates. The Joint Committee estimate assumes a somewhat smaller long-run taxpayer response to the lower capital gains tax rate. While our estimated response is significant enough to offset approximately 70 percent of the so-called "static" revenue loss (Table 1, line 1), it is not large enough to show a long-run revenue increase. This is the most significant difference between the two estimates.

Beyond the difference in taxpayer response, there are several more minor differences between the estimates. First, the assumption as to the annual levels of capital gains realizations under the CBO budget baseline differs from that of the Administration. These differences, on the order of $20 to $30 billion annually, are due both to economic forecasts and differing assumptions as to the effect of the Tax Reform Act of 1986 on the subsequent realization of capital gains and losses. (CBO estimates a higher baseline level of realizations than does the Office of Management and Budget.)

Second, the Administration's proposal allows for a phase-in period after which only assets held for three or more years would be eligible for the reduced rate. The Joint Committee and Treasury estimates differ slightly on both the amount of asset sales which would be affected by this provision and on the extent to which taxpayers are able to postpone their realizations to take advantage of the lower rate. That is to say when, in 1993, only assets held for two or more years are eligible for the 45 percent exclusion, taxpayers with assets held for less than the prescribed amount of time have the option of postponing any sales until they qualify for the reduced rate. We anticipate that some taxpayers will speed-up their realizations to take advantage of the one-year holding period still available in 1992. Of those taxpayers who do not speed-up their realizations, some will wait until 1994 to qualify for the new two-year holding period. A similar argument holds when the holding period increases to three years in 1995.

Third, the offices differ somewhat on their estimate of the proportion of assets which would be eligible for the exclusion. This difference arises primarily from small differences in assumptions about the percentage of accrued gains held in the form of corporate stock, real estate, depreciable property, and collectibles.

Fourth, the Joint Committee assumes more taxpayers will be able to temporarily lower their adjusted gross incomes through the timing of business losses, for example, and thereby realize capital gains at tax rates below 15 percent.

It is important to emphasize that neither our revenue estimates nor Treasury estimates are made in a vacuum. Our staff regularly communicates with those of the Treasury Department, the Congressional Budget Office, and the Congressional Research Service, as well as with academic economists and others who are knowledgeable about capital gains and revenue estimating methodology. Ultimately, however, we make an independent judgement of how any tax change will affect the market place.

Many times the Joint Committee estimate and the Treasury

estimate are nearly identical. Occasionally we disagree, as we do on the estimate of the Administration's capital gains proposal. However, our disagreement on the estimate is not total. Subject to our constraints to use different baseline assumptions, both the Joint Committee and Treasury estimate the Administration's proposal will result in a "static" revenue loss of $20 to $25 billion dollars per year (i.e., one that disregards the taxpayer response to the tax change) (Table 1, line 1). Moreover, both estimates contain substantial taxpayer behavioral response. The estimate we have made predicts that in the long run, changes in taxpayer response will be sufficient to offset approximately 70 percent of that static revenue loss. Treasury estimates that something over 100 percent of the static loss will be offset. While one might conclude that this difference merely is one of magnitude, I want to emphasize it represents a very significant difference in judgment about taxpayer response.

IV. Discussion of Taxpayer Behavioral Response

A. General

As I stated above, the bulk of the difference between the Joint Committee estimate of the revenue effects of the Administration's capital gains proposal and the estimate made by the Treasury Department lies in different estimates of the magnitude of taxpayer behavioral response to the rate reduction. When taxpayers respond to a reduction in tax rates by realizing more gains, we refer to these additional gains as "induced realizations."

We arrived at our estimate after considering the many academic and government studies which have attempted to analyze how taxpayers respond to changes in capital gain tax rates and after undertaking our own analysis. In fact, members of our staff have contributed to the academic literature. Eric Cook, a former staff economist, and John O'Hare, a staff economist, published a paper which was the first to investigate the empirical importance of the effect of a preference for capital gains on the realization of dividend and interest income. This issue is referred to as the so-called "portfolio effect." [3]

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[3] See Eric W. Cook and John F. O'Hare, "Issues Relating to the Taxation of Capital Gains," National Tax Journal, vol. 60, September 1987.

Thomas Barthold, a staff economist, has also written papers on the subject. See Thomas A. Barthold, "In Search of a Test of Investor Capital Gain Realization Behavior to Capital Gain Tax Rates," Economics Letters, vol. 12, 1983, and "Investor

(Footnote continued)

An examination of the economic literature reveals that economic science does not speak with one voice on this issue. And, one of the first things any of these researchers will tell you is that his or her study is not perfect. To quote Professor Joel Slemrod of the University of Michigan, who has undertaken several studies of capital gain realization behavior,

> [T]he estimated tax responsiveness of capital gains realizations can be quite sensitive to the exact specification of the empirical model. In fact a specification search whose sole objective was to disprove the existence of a lock-in effect could be successful, as could a specification search designed to establish a large and significant lock-in effect. In this sense the data do <u>not</u> speak with one voice.[4]

Moreover, the empirical studies have created a substantial academic debate over methodological issues.

In these studies, economists characterize taxpayer behavior in terms of what they call an "elasticity." Mathematically, an elasticity for capital gains with respect to the tax rate is the percentage change in realized capital gains divided by the percentage change in the tax rate. This is merely a convenient mathematical way to measure taxpayer responsiveness. At its most basic level, the greater the responsiveness of taxpayers to a tax change, the greater the elasticity.

B. Methods of Empirical Analysis

The studies which have attempted to measure the elasticity of capital gain realizations with respect to capital gain tax rates have taken three primary forms: cross section studies; panel studies; and time series studies.

<u>Cross section studies.</u>--Briefly, a cross section study uses data on many taxpayers from one year. For example, the data may consist of a random selection of 10,000 tax returns all filed for 1985. Among the 10,000 taxpayers some will

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[3](continued)
Capital Gains Realization Behavior in Response to Capital Gains Tax Rates," Dartmouth College, December 1986.

[4] Joel Slemrod and William Shobe, "The Tax Elasticity of Capital Gains Realizations: Evidence from a Panel of Taxpayers," xerox, University of Michigan, February 1989.

face high marginal tax rates and some will face low marginal tax rates. Some will realize many capital gains, and some will realize few capital gains. These studies try to infer the elasticity by relying on differences in tax rates and realizations across the sample of taxpayers.

The major problem with cross section studies is that they rely on only one year for observation. Because taxpayers have the discretion to realize capital gains in a year when their marginal tax rate is low, and perhaps deliberately made so by successful tax sheltering, the studies cannot tell us what the long run effect would be to a change in tax rates. Cross section studies also cannot attempt to measure macroeconomic variables, for example GNP growth or inflation, which may be important.

Panel studies.--A panel study also uses data on a cross section of taxpayers but, in addition, follows these taxpayers across two or more years. So a panel study may look at the tax returns for the same 10,000 taxpayers for each of 1985, 1986, and 1987.

While many researchers might prefer to work with panel data because they combine both individual information with changes that occur over time, there have been relatively few panel studies and they have often had poor data with which to work. For example, the first panel study undertaken[5] utilized a sample of only approximately 1,000 taxpayers; when the analysis was restricted to high income taxpayers the sample of taxpayers was approximately 250. The data only tracked these taxpayers for a period of five years. Even the Treasury Department's study,[6] while having the advantage of a panel of approximately 17,000 taxpayers only has data from five years in the early 1970s and uses a statistical form which limits the analysis of realizations to three years, years when there were no significant changes in the taxation of capital gains.

Time series studies.--A time series study uses aggregate data, rather than individual specific data, but uses data available for many years. A typical time series study will employ some measure of realizations for each year between 1954 and the present and construct an average marginal tax rate on gains for each year.

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[5] Gerald E. Auten and Charles T. Clotfelter, "Permanent versus Transitory Tax Effects and the Realization of Capital Gains," Quarterly Journal of Economics, November 1982.

[6] U.S. Treasury Department, Office of Tax Analysis, Report to Congress on the Capital Gains Tax Reductions of 1978, September 1985.

The major failing of time series studies is that they lack the individual specific data available in either cross section or panel studies. For example, the tax rate variable must be some sort of average marginal tax rate, or a hypothetical tax rate which need not apply to any specific taxpayer. Nor can a time series study control for the amount of interest or dividend income an individual taxpayer receives.

C. Predictive Ability of Empirical Studies

Without detailing the academic debate about the validity of these studies, from the point of view of producing a revenue estimate, the results of some of the studies must be discounted. For example, one academically important and often quoted study was undertaken by Feldstein, Slemrod, and Yitzhaki.[7] In one of its estimates the authors estimated a very high elasticity, so high that if one used it to predict capital gain realizations which would have resulted from the 1978 cut in capital gain tax rates, one would have predicted that, even accounting for other factors, realizations would have immediately and permanently tripled. In Table 2 we have reproduced a chart of capital gain realizations prepared by the Congressional Budget Office.[8] An examination of this table suggests that while there appears to have been a substantial taxpayer response to the 1978 tax cut, there clearly was not a tripling of gain realizations.

Similarly, Dr. Lawrence Lindsey of Harvard University employed a panel study[9] to estimate the revenue effects of the Tax Reform Act of 1986. Based on his analysis, with an implicitly high elasticity he predicted that 1987 capital gain realizations would be $83.6 billion. In fact, the Internal Revenue Services' Statistics of Income Division reports that actual 1987 realizations were $137 billion.

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[7] Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains, Quarterly Journal of Economics, vol. 94, June 1980.

[8] CBO, How Capital Gains Tax Rates Affect Revenues: The Historical Evidence, March 1988, pp. 25.

[9] Lindsey's panel is a panel of aggregate taxpayer adjusted gross income classes rather than a panel with individual specific data. See Lawrence B. Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," National Tax Journal, vol. 60, September 1987.

A possible explanation for this discrepancy might lie in the fact that Lindsey constructed his own series of baseline realizations to describe realizations in the absence of tax reform. His baseline may be lower than the comparable CBO baseline by 25 percent. However, even increasing his predicted 1978 realizations by 25 percent to $105 billion leaves his model far from the historical mark.[10]

I present these two examples not to criticize these two publications specifically or the quality of the academic literature in general. There is no question taxpayer response to a change in the capital gains tax rate is inherently difficult to address empirically. Rather, I refer to these two examples to suggest that the results of some of the studies predicting high elasticities lead to conclusions which are sufficiently inconsistent with history to lead our staff to discount them when arriving at a revenue estimate.

D. Summary

Typically, cross section studies have estimated higher elasticities than either panel or time series studies. The results of the time series and panel studies are somewhat similar in terms of order of magnitude while still containing sometimes substantial differences in their estimates of consumer behavior.

The paucity of yearly data in cross section studies and the existing panel studies may not permit these studies to adequately account for the effects that economic and stock market growth have on the pattern of gain realizations. In this regard Table 2 is again instructive. Table 2 shows that between 1954 and the early 1960s, gain realizations approximately doubled as nominal GNP grew by approximately 60 percent. This was a period when there were virtually no statutory changes affecting capital gains taxation. Between 1963 and 1973 the economy approximately doubled while gain realizations approximately doubled, and again during the majority of that period there was little change in taxes on capital gains. Table 2 and Figures 1 and 2 continue to show a relationship between gains and GNP to the present day.

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[10] This is a conservative analysis of Lindsey's estimate, because Lindsey claims to be estimating the permanent effect of the tax change. The 1986 and 1987 actual data reflect substantial short-term shifting of asset realizations in response to the announced tax change, leading to the actual 1986 realizations exceeding permanent realizations and 1987 realizations at a level likely to be below permanent realizations. Consequently, the actual 1987 figure is less than what one should expect as a permanent effect.

This is not to suggest that all realizations are explained by GNP growth, but I think that we have to recognize that more than taxes can matter. Gain realizations also appear to move in reasonably close step with stock market performance as Figure 3 suggests. I make these observations because we believe it is important to account for these potential factors. Most time series studies, while lacking individual specific data, do account for factors such as GNP and stock market growth. As a result, while not ignoring the cross sectional and panel results, we rely most heavily on the results of time series analysis. We believe these studies are most consistent with the historical record.

In our estimate of the Administration's proposal we used a short-run elasticity of 1.20 and a long-run elasticity of 0.71 to measure the taxpayer behavioral response.[11]

We arrived at these elasticities based on our own analysis and our critical reading of the existing literature as discussed above. They correspond to no published study because no published study has limited its analysis to solely financial securities and non-depreciable real estate as the Administration's proposal attempts to do, and we have had to account for this targeting. Some may criticize these elasticities as too low and others as too high, but they represent our best judgement of the likely taxpayer behavioral response.

V. Plausibility of the Estimate

Because the Administration proposes a reduction in the tax rate on capital gains of approximately 50 percent, for the Joint Committee staff to have estimated that the Administration's proposal would be a <u>permanent</u> revenue raiser we would have to conclude that gain realizations would more than double, <u>and</u> this doubling would have to occur after one has already accounted for the growth of the economy on future gain realizations. For example, if the proposal had been effective from the beginning of this year, when the stock market is not markedly higher than in 1986, gain realizations would have to approximately equal the levels realized in 1986, a year which everyone believes was dominated by the timing effects induced by the announcement of a pending tax rate hike. We simply do not believe this conclusion is realistic and surely is not supported by historic realizations following past capital gains rate reductions when adjusted for economic growth.

In the <u>seven-year</u> period between 1981 and 1987

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11 In these elasticities we include the so-called "portfolio effect," the ability of taxpayers to convert ordinary income to capital gain income.

taxpayers realized a total of approximately $1 trillion of capital gains. This seven-year period follows the 1978 and 1981 capital gains rate cuts and includes what is probably the strongest bull stock market in the nation's history. It also includes the tremendous temporary unlocking which occurred in 1986. For the Administration's proposal to generate permanent revenue increases in the five-year period from 1991 through 1995 (after the short-term effects of 1990), taxpayers would have to realize more than $2 trillion in gains.

While we project an initial surge in realizations (see Figure 2), we do not believe realizations will continue to surge on a permanent basis in relation to the nation's gross national product. Such a sustained increase in realizations in comparison to GNP appears to be outside the historical record (see Figure 2).[12]

The Treasury predicts a substantial increase in realizations. This can only come from two sources: one, taxpayers churning their portfolios faster; and two, unlocking of accrued gains which otherwise would have been held until death. If the only response to a rate cut is that taxpayers churn their portfolios faster, then the predicted realizations merely are being accelerated from a future date to the present. If this were the case, the long-run elasticity would be, in fact, approximately zero and ultimately the proposal must lose revenue.

We believe that it is implausible that the other source of increased realizations, gains which would otherwise be held until death, would be unlocked in substantial enough numbers to produce a permanent revenue gain. A 15 percent tax rate, while less than a 28 percent tax rate, is still significantly greater than the tax rate of zero a taxpayer can attain by holding an asset with an accrued gain until death. This leaves a strong incentive for many accrued gains to remain unrealized until death.

In addition, many overstate the penalty on a gain realized while living relative to that at death. While we do not tax capital gains at death, the estate tax is assessed on that part of gain which escapes tax when held until death. For taxpayers in the 50 percent estate tax bracket, this rule has the effect of reducing the capital gains tax on an

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12 We believe that in interpreting the surge of realizations in the early 1980s one must be careful to remember that not only was the economy in the middle of one of the largest bull markets in our history, but that the Congress also enacted substantially improved reporting requirements on the disposition of capital assets.

accrued gain from 28 to 14 percent. The Federal Reserve's Flow of funds data indicate that for 1982 the market value of corporate equities was $1.24 trillion. Of this amount, 83 percent, or $1.03 trillion, was owned by individuals.[13] Of that amount $738 billion, or 71.6 percent, was owned by individuals with gross assets in excess of $500,000, and thereby potentially liable for the estate tax.[14] From this perspective, the gain from waiting until death is to reduce the effective tax rate from 14 percent to 7.5 percent.

Admittedly dropping the tax rate from 28 percent to 15 percent may constitute the largest tax cut on capital gains in history, but the difference between the 15 percent rate from the top rate of 20 percent the nation had from 1981 through 1986 is small. We do not believe the historical record substantiates that a massive amount of unlocking of these gains will be forthcoming.

VI. Conclusion

It has been said that revenue estimating is as much an art as it is a science. Certainly all would agree that it is not an exact science. But economic theory and econometric methods are much more sophisticated than most of us realize. Revenue estimating assuredly is much more than an art.

The revenue effects of capital gains is a subject that has been debated extensively both within and outside government for many years. This year's discussion among economists and policy makers will not end that debate.

Every estimate is subject to uncertainty. However, in spite of this uncertainty, the Joint Committee has a job to do, namely, to provide the Congress the most informed and reasoned point estimate of the revenue impact of a proposed tax law change as we possibly can.

This certainly is not to say our estimate is necessarily correct. After all, it is an estimate. But I do believe the analysis we have employed in arriving at our estimate of the Administration's capital gains proposal reflects the best and most reliable of the economic theory and most accords with the history of prior capital gains rate adjustments. We believe a capital gains rate change will result in a significant short-run behavioral effect and more modest permanent behavioral effects. It is an analysis which is consistent with realizations following the rate reductions of

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[13] See, Joint Committee on Taxation, Federal Income Tax Aspects of Corporate Financial Structures, JCS-1-89, January 18, 1989, pp. 14.

[14] See Marvin Schwartz, "Estimates of Personal Wealth, 1982: A Second Look," SOI Bulletin, vol. 7, Spring 1988.

1978 and 1981. It is an analysis which is inconsistent with a prediction of permanently doubled realizations. And, it is our judgment that it is the most reliable analysis for use today.

Accompanying me today are Randall Weiss, Deputy Chief of Staff of the Joint Committee, and Thomas Barthold, a member of the Joint Committee's staff of economists. We will be pleased to try to respond to your questions.

Table 1
REVENUE ESTIMATES OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

Fiscal Years 1989-1999[1]/

[Billions of Dollars]

	Item[2]/	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
I)	45% Exclusion											
	"Static" Effect	-3.1	-20.8	-23.4	-25.4	-27.1	-27.8	-28.6	-30.1	-31.7	-33.3	-35.0
	Induced Realizations	3.3	21.4	17.2	16.6	17.4	16.2	16.6	17.5	18.4	19.4	20.4
	Total, 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	-12.0	-12.6	-13.2	-13.6	-14.7
II)	Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
III)	Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	3.3	3.4	3.6	3.8	4.0
IV)	Transition to 3-year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	2.2	-1.6	3.3	2.5	2.7
V)	Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	-0.6	-0.6	-0.7	-0.8	-0.9
	Total, Revenue Effect	**0.7**	**3.3**	**-4.0**	**-6.4**	**-6.9**	**-10.9**	**-7.1**	**-11.4**	**-7.0**	**-8.4**	**-8.9**

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NOTE: Totals may not add due to rounding.

1/ The official CBO baseline extends only through fiscal year 1994. Estimates for fiscal years 1995 through 1999 assume that the CBO baseline assumption for realizations continues to grow at the average rate of growth of the period 1990 through 1994.

2/ Item I has three subparts. The third is the net revenue effect which would result from a 45 percent exclusion, with a maximum 15 percent tax rate, for capital gains regardless of asset type assuming a one-year holding period and an effective date of sales on or after January 1, 1989. The first subpart shows the "static" revenue effect, that is the revenue effect assuming no taxpayer behavioral response. The second subpart, "induced realizations," shows the effect on revenues of new

realizations undertaken and conversion of ordinary income to capital gain by taxpayers in response to the preferential rate.

Item II presents the estimated revenue effect resulting from moving the effective date of the proposal to July 1, 1989.

Item III presents the estimated revenue effect resulting from excluding collectibles and depreciable property.

Item IV presents the revenue effect of the lengthening, on a phased-in basis, of the holding period.

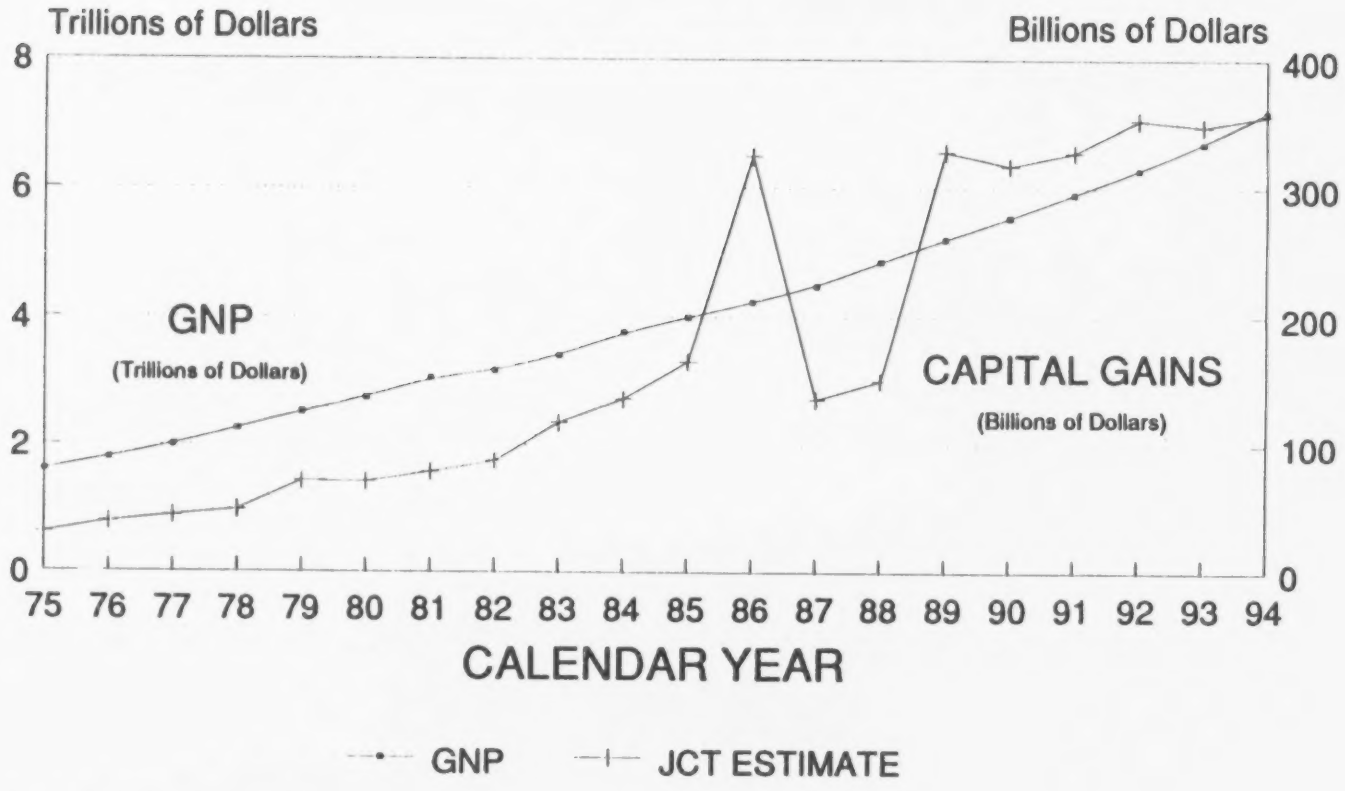
Item V presents the effect of providing a 100-percent exclusion to those eligible taxpayers with adjusted gross income less than $20,000.

Table 2
Congressional Budget Office
Calculation of Realization of Net Long-Term Gains
and National GNP

Year	Realization of Net Long-Term Gains (billions of dollars)	Year-to-Year Percentage Change in Realizations	Gross National Product (billions of dollars)	Year-to-Year Percentage Change in GNP
1954	7.0	--	372.5	--
1955	9.7	38.6	405.9	9.0
1956	9.6	-1.0	428.1	5.5
1957	8.2	-14.6	451.0	5.3
1958	9.3	8.1	456.8	1.3
1959	12.9	38.7	495.8	8.5
1960	11.7	-9.3	515.3	3.9
1961	15.7	34.2	533.8	3.6
1962	13.6	-13.4	574.6	7.6
1963	14.5	6.6	606.9	5.6
1964	17.0	17.2	649.8	7.1
1965	20.8	22.4	705.1	8.5
1966	21.8	4.8	772.0	9.5
1967	27.3	25.2	816.4	5.8
1968	35.8	31.1	892.7	9.3
1969	32.6	-8.1	963.9	8.0
1970	21.3	-34.7	1,015.5	5.4
1971	28.2	32.4	1,102.7	8.6
1972	36.1	28.0	1,212.8	10.0
1973	35.8	-0.8	1,359.3	12.1
1974	30.0	-16.2	1,472.8	8.3
1975	30.7	2.3	1,598.4	8.5
1976	39.2	27.7	1,782.8	11.5
1977	44.4	13.3	1,990.5	11.7
1978	48.9	10.1	2,249.7	13.0
1979	71.3	45.8	2,508.2	11.5
1980	70.8	-0.7	2,732.0	8.9
1981	78.3	10.6	3,052.6	11.7
1982	87.1	11.2	3,166.0	3.7
1983	117.3	34.7	3,405.7	7.6
1984	135.9	15.9	3,765.0	10.5
1985	165.5	21.8	3,998.1	6.2

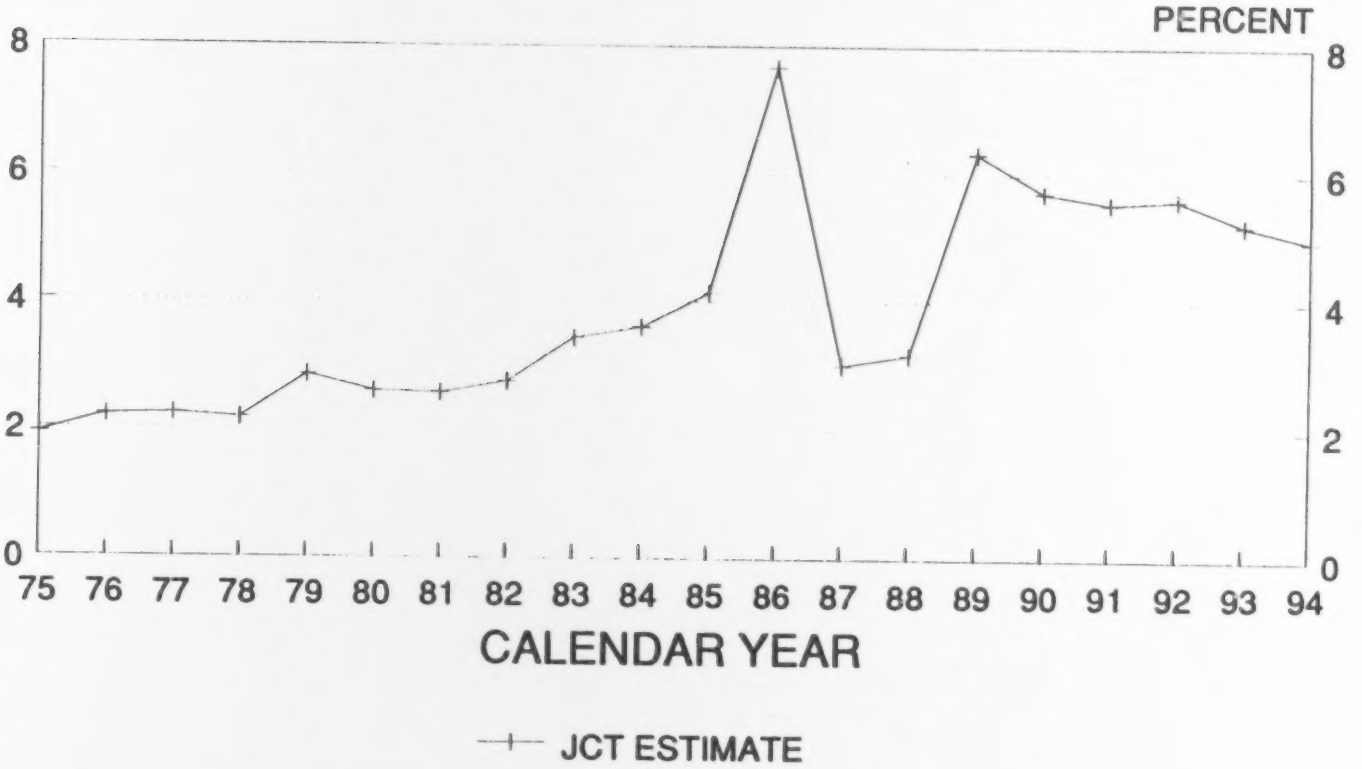
Source: CBO, How Capital Gains Tax Rates Affect Revenues: The Historical Evidences, March 1988.

Figure 1.
CAPITAL GAINS AND GNP
HISTORICAL AND FORECAST 1/



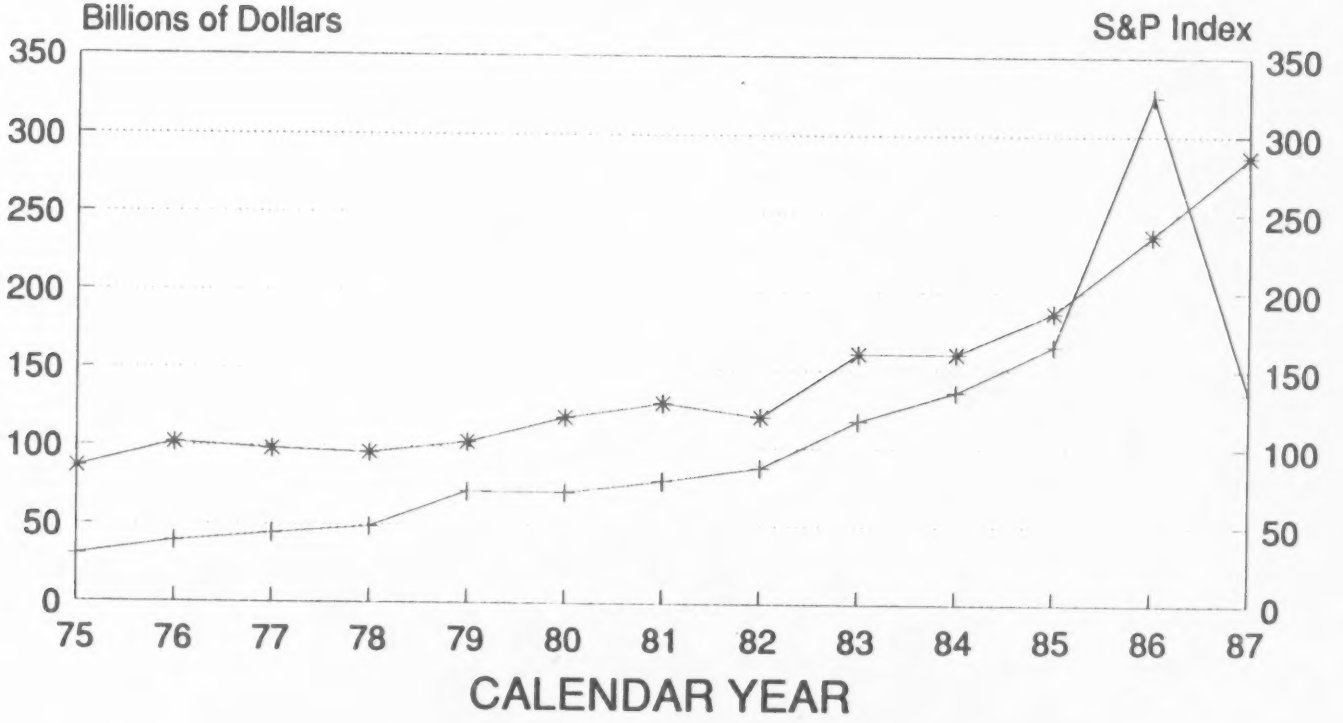
Source: Joint Committee on Taxation
1/ Prior to 1988, actual values are shown.

Figure 2.
CAPITAL GAINS AS A PERCENT OF GROSS NATIONAL PRODUCT [1/]



Source: Joint Committee on Taxation
1/ Prior to 1988, actual values are shown.

Figure 3.
CAPITAL GAINS AND THE STOCK MARKET
1975 to PRESENT



Source: Joint Committee on Taxation